

Message Text

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FM AMEMBASSY MADRID

TO SECSTATE WASHDC PRIORITY 1175

INFO AMEMBASSY LISBON

AMEMBASSY PARIS

C O N F I D E N T I A L SECTION 1 OF 3 MADRID 5632

USOECD

FOR STATE, TREASURY, COMMERCE, EXIM, STR

E.O. 11652: GDS

TAGS: ECON, PINT, EFIN, ENRG, SP

SUBJECT: SPANISH GOVERNMENT OUTLINES ECONOMIC MEASURES

REF: MADRID 5489

1. SUMMARY: THE SUAREZ GOVERNMENT HAS ANNOUNCED AN ECONOMIC PROGRAM WHICH IS A COMBINATION OF REFORM, MILD BELT TIGHTENING, AND SOME MEASURES TO RELIEVE UNEMPLOYMENT. IF ALL CAN BE CARRIED TO FRUITION, THERE SHOULD BE SO DAMPENING OF THE DANGEROUS WAGE/PRICE SPIRAL. THE CENTERPIECE OF THE GOVERNMENT'S ANNOUNCEMENT WAS THE EXPECTED TAX REFORM PROPOSAL (REFTEL) WHICH IS FEARED AND OPPOSED BY THE WEALTHY BUT FAVORED BY LABOR AND THE POLITICAL OPPOSITION. WHILE THE SHORT-TERM ECONOMIC EFFECT OF SUCH REFORM WOULD BE NEGLIGIBLE, THE ADVENT OF AN EFFECTIVE AND MORE EQUITABLE TAX

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SYSTEM IS A NECESSARY TRADE-OFF FOR ACCEPTANCE OF AUSTERITY AND WOULD BE AN HISTORIC SOCIAL IMPROVEMENT. OF GREATER IMPORTANCE FOR IMMEDIATE ECONOMIC PROBLEMS ARE PLANS FOR A MORE RESTRICTIVE MONETARY POLICY AND THE GOVERNMENT'S INTENTION TO NEGOTIATE LABOR ACQUIESCENCE TO AN ACROSS THE BOARD LIMITATION ON ANNUAL WAGE INCREASES. IN ADDITION TO THE ALREADY ACCOMPLISHED DEVALUATION, THE

MOST IMPORTANT TRADE MEASURE ANNOUNCED WAS TERMINATION OF THE 20 PERCENT SURTAX ON IMPORTS. ANY NEW PROTECTIONIST MEASURES WERE CONSPICUOUSLY ABSENT. FOLLOWING THE PROGRAM ANNOUNCEMENT, THE GOVERNMENT HAS ALREADY ACTED TO RAISE PRICES FOR ENERGY, COFFEE AND SOYBEAN OIL, TO INCREASE THE BANK OF SPAIN'S BASIC LENDING RATE TO 8 PERCENT, TO LIBERALIZE INTEREST RATES FOR LOANS OVER ONE YEAR, AND TO REDUCE CONTROLS ON INVESTMENT OF BANK RESERVES. TO FIGHT UNEMPLOYMENT, PUBLIC WORKS WILL INCREASE SUBSTANTIALLY AND BUSINESSES WILL RECEIVE TAX CREDIT FOR NEWLY CREATED JOBS. WHILE THE AUSTERITY MEASURES APPEAR FAIRLY SEVERE TO THE AVERAGE SPANIARD, THEY CONSTITUTE A MILD BELT TIGHTENING RATHER THAN A FULL SCALE STABILIZATION PROGRAM. THE MEASURES ARE ALL INDICATED BY SPAIN'S MOST PRESSING ECONOMIC PROBLEMS, BUT WILL PROBABLY NOT BEGIN TO HAVE A SIGNIFICANT IMPACT UNTIL NEXT YEAR. THE MOST IMPORTANT QUESTIONS ARE HOW RESTRICTIVE MONETARY POLICY WILL BE, AND HOW SUCCESSFUL THE GOVERNMENT WILL BE IN GAINING LABOR ACCEPTANCE OF WAGE CONTROLS AND PARLIAMENTARY APPROVAL OF TAX REFORM. INITIAL PUBLIC REACTION HAS BEEN LARGELY NEGATIVE, AND FOR FULL IMPLEMENTATION OF ITS PROGRAM THE GOVERNMENT WILL HAVE TO MUSTER ALL OF ITS SKILLS OF NEGOTIATION AND PERSUASION. END SUMMARY.

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2. IN A MIDNIGHT ANNOUNCEMENT FOLLOWING LAST SATURDAY'S COUNCIL OF MINISTERS MEETING, THE SUAREZ GOVERNMENT FLESHED OUT DETAILS ON SUBSTANCE AND TIMING OF ITS ECONOMIC PROGRAM. THE PROGRAM IS A COMBINATION OF ECONOMIC REFORM AND MILD BELT TIGHTENING, COMBINED WITH ADDITIONAL PUBLIC EXPENDITURES TO REDUCE UNEMPLOYMENT. THROUGHOUT, THERE IS A THREAD OF CONTINUITY: THE LONG TERM STRENGTHENING OF MARKET FORCES IS STRESSED AND AN ABRUPT STABILIZATION IS RULED OUT. IT IS A BROAD PROGRAM DESIGNED TO OPERATE IN FIVE GENERAL AREAS: (A) FISCAL REFORMS AND INCOMES POLICY; (B) MORE RESTRICTIVE MONETARY POLICY; (C) MEASURES TO COMBAT UNEMPLOYMENT; (D) MODEST MEASURES TO REDUCE THE BALANCE OF PAYMENTS DEFICIT; AND (E) MEASURES TO PROMOTE COMPETITION. IF THE GOVERNMENT IS ABLE TO PROMOTE COMPETITION. IF THE GOVERNMENT IS ABLE TO CARRY OUT ALL OF THE MEASURES IT PROPOSES, THE PROGRAM SHOULD BE FULLY OPERATIVE BEFORE THE END OF THE YEAR. SOME ESSENTIAL ELEMENTS OF THE PLAN HAVE ALREADY BEEN IMPLEMENTED: THE JULY 11 DEVALUATION OF THE PESETA, THE SUBSEQUENT STRENGTHENING OF PRICE SURVEILLANCE, WEEKEND PRICE HIKES FOR GASOLINE,

FUEL OILS, ELECTRICITY, COFFEE AND SOYBEAN OIL, AND THE BEGINNINGS OF IMPORTANT MONETARY CONTRACTION. OTHER ELEMENTS OF THE PACKAGE WILL TAKE LONGER. SOME BASIC TAX REFORMS, WHICH WILL BE WELL RECEIVED BY LABOR AND THE OPPOSITION BUT ARE CERTAINLY UNPOPULAR WITH THE WEALTHY THEY WILL HIT, WILL REQUIRE NEW LEGISLATION OR WILL OBTAIN APPROVAL OF NEWLY FORMED PARLIAMENTARY COMMITTEE ON LEGISLATIVE URGENCY FOR ISSUANCE AS DECREE LAWS. PERHAPS MOST IMPORTANTLY, LABOR ACQUIESCENCE MUST BE NEGOTIATED FOR THE GOVERNMENT'S CRUCIALLY-IMPORTANT ATTEMPT TO CONTROL WAGES.

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INFO AMEMBASSY LISBON
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3. TAX MEASURES: TAX REFORM IS CONSIDERED ESSENTIAL TO ENHANCE THE ACCEPTANCE OF BELT TIGHTENING MEASURES AND TO INCREASE GOVERNMENT REVENUE. AS A FIRST STEP IN THIS DIRECTION, THE GOVERNMENT WILL SEEK CORTES EMERGENCY APPROVAL, PROBABLY FOR DECREE LAWS, TO ESTABLISH TAX FRAUD AS A CRIME, TO ALLOW STRICTLY-CONTROLLED TAX INSPECTION OF BANK RECORDS, TO DECLARE A MORATORIUM ON THE PREVIOUS TAX MISDEEDS OF MOST SPANIARDS, AND TO PLACE A PAYROLL SURTAX ON HIGH INCOMES. AT AN EARLY DATE LUXURY TAXES ARE TO BE RAISED. THESE ARE ALL TO BE IMPLEMENTED URGENTLY FOLLOWING APPROVAL OF A PARLIAMENTARY COMMISSION. LATER, BUT BEFORE SEPTEMBER 30 THE GOVERNMENT WILL PRESENT A LEGISLATIVE BILL TO ESTABLISH MINIMAL WEALTH AND DEATH ESTATE TAXES AND TO RAISE INCOME TAXES FOR THE WELL-TO-DO. ALTHOUGH THIS BILL MAY NOT IMMEDIATELY SWELL THE GOVERNMENT COFFERS IT WILL BE

A SERIOUS EFFORT TO DRAW THE WEALTHY INTO SPAIN'S TAX SYSTEM. BEFORE NOVEMBER 30 A BILL WILL BE PRESENTED TO MODIFY THE INDIRECT TAXATION SYSTEM (PROBABLY SUBSTITUTING A COMMON MARKET-STYLE VALUE ADDED TAX FOR SPAIN'S PRESENT INFLATIONARY CASCADE TAX SYSTEM
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AND CHANGING SOCIAL SECURITY FINANCING) AND TO TAX LAND PECULATION. THESE PROPOSED TAX MEASURES, TOGETHER WITH A MUCH-PROMISED INCREASE IN ENFORCEMENT, ARE THE SEEDS FOR A MODERN SYSTEM OF TAXATION AND COULD IN TIME HAVE FAR-REACHING SOCIAL SIGNIFICANCE. IN PART FOR THIS REASON, THE TAXES ON WEALTH AND ON ESTATES AND THE INCREASE IN THE PAYROLL INCOME TAX WILL BE MODERATE.

4. WAGE HIKE LIMITS: THE GOVERNMENT FORMALLY ANNOUNCED IT WILL NEGOTIATE WITH LABOR REPRESENTATIVES AND POLITICAL LEADERS A MAXIMUM ALLOWABLE ANNUAL PAY INCREASE. THIS TYPE OF LIMITATION HAS A PROGRESSIVE EFFECT, PROTECTING MORE FULLY LOWER-PAID WORKERS' REAL WAGES. SINCE THE PROGRAM ANNOUNCEMENT THE MINISTER OF LABOR HAS ASKED LABOR LEADERS TO ACCEPT 50,000 PESETAS (573 DOLLARS) AS THE MAXIMUM ANNUAL INCREASE. THE GOVERNMENT REPORTEDLY ESTIMATES THAT SUCH A CEILING WOULD LIMIT THE INCREASE IN THE SALARY MASS TO AN ANNUAL RATE OF 19 PERCENT, AND THAT THIS WOULD MAKE A MODEST BUT ESSENTIAL CONTRIBUTION TO DAMPENING THE WAGE/PRICE SPIRAL. ALTHOUGH THE SUBJECT OF WAGE LIMITS IS CRUCIAL TO THE ECONOMIC PROGRAM, IT WILL NOT BE EASILY "NEGOTIATED" WITH THE WORKERS. THE INITIAL RESPONSE OF LABOR IS KNOWN TO VARY FROM "NO COMMENT" TO "NO.", BUT THE QUESTION STILL REMAINS TO BE NEGOTIATED.

5. PRICES AND PRICE CONTROLS: THE GOVERNMENT'S PROGRAM ANNOUNCEMENT STATED THAT MEANINGFUL PRICE CONTROLS CAN BE INTRODUCED ONLY IN CONNECTION WITH AN AGREED LIMIT ON WAGE HIKES. SO FAR THERE ARE NO EFFECTIVE CONTROLS ON THE PRICES OF MOST GOODS AND SERVICES. IN THE OPPOSITE DIRECTION, TO GET SOME
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BENEFIT FROM THE RECENT 25 PERCENT DEVALUATION, THE GOVERNMENT THIS WEEKEND RAISED GASOLINE PRICES AN AVERAGE 20 PERCENT, ELECTRICITY 5.36 PERCENT, AND COFFEE AND SOYBEAN OIL BY SUBSTANTIAL MARGINS. MORE

INCREASES IN CONTROLLED PRICES ARE EXPECTED.

6. FINANCIAL MEASURES: IN THE FUTURE THE GROWTH OF THE MONEY SUPPLY WILL BE MODERATED, FALLING SLIGHTLY FROM THE 23 PERCENT ANNUAL RATE MAINTAINED SINCE LAST SEPTEMBER. THE BANK OF SPAIN BASIC INTEREST HAS BEEN INCREASED A FULL ONE PERCENT FROM THE PRESENT TOO-LOW SEVEN PERCENT, AND PRIVATE INTEREST RATES FOR PERIODS LONGER THAN ONE YEAR HAVE BEEN LIBERALIZED WHICH WILL MEAN THEY WILL ALSO RISE. IN ADDITION, CONTROLS ON INVESTMENT OF BANK RESERVES HAVE BEEN RELAXED. THE INTENTION IS TO ENCOURAGE SAVINGS WHILE INCREASING BANK COMPETITION. UNSPECIFIED ADDITIONAL MEASURES WILL BE TAKEN TO BREAK THE HOLD ON LOAN MONEY OF THE "PRIVILEGED FINANCIAL CIRCUITS," WHICH EXIST BETWEEN BIG BANKS AND BIG BUSINESSES.

7. UNEMPLOYMENT MEASURES: THE GOVERNMENT WILL PROPOSE A TAX CREDIT OF ABOUT 240 PER NEW JOB FOR BUSINESSES THAT INCREASE THEIR LABOR FORCES. PUBLIC WORKS WILL BE INCREASE, ESPECIALLY PUBLIC HOUSING. REPORTEDLY, THE GOVERNMENT WILL EXPAND SUCH EXPENDITURES BY 84 MILLION PESETAS (NEARLY A BILLION DOLLARS) IN ORDER TO GENERATE 160,000 NEW JOBS. THE FUNDING OF THE UNEMPLOYMENT COMPENSATION PROGRAM WILL ALSO INCREASE. SOME OF THE INFLATIONARY IMPACT OF THESE EXPENDITURES WILL BE OFFSET BY THE PRICE RISES AUTHORIZED FOR GASOLINE AND OTHER GOODS SOLD BY THE GOVERNMENT.

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FOR STATE, TREASURY, COMMERCE, EXIM, STR

8. TRADE AND PAYMENTS: SINCE THE DEVALUATION OF THE PESETA PRECEDED THE ECONOMIC PROGRAM ANNOUNCEMENT, THE MOST SIGNIFICANT NEW TRADE AND PAYMENTS MEASURE IN THE PLAN WAS ELIMINATION OF THE 20 PERCENT SURTAX ON SPANISH IMPORT TARIFFS. THE ELIMINATION OF THIS BLANKET TARIFF HIKE IS A WELCOME MEASURE TO REDUCE AN ILL-PLANNED TRADE BARRIER. THE GOVERNMENT WISELY REJECTED INCREASED PROTECTIONISM IN THE FORM OF ADDITIONAL QUANTITATIVE RESTRICTION OR A PRIOR IMPORT DEPOSIT SCHEME.

9. COMMENT. THE GOVERNMENT HAS OPTED AGAINST A FULL SCALE STABILIZATION PROGRAM AS POLITICALLY UNACCEPTABLE. NEVERTHELESS, IT IS EVIDENT THAT THE GOVERNMENT IS BEGINNING AN HISTORIC ECONOMIC REFORM AND INTENDS TO IMPOSE A MEASURE OF BELT TIGHTENING
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THAT WILL BEGIN TO REVERSE THE WAGE/PRICE SPIRAL THAT HAS EXACERBATED THE BALANCE OF PAYMENTS PROBLEM. DETAILS FOR A FULL EVALUATION OF THE PROGRAM ARE NOT YET AVAILABLE, BUT PRICE INCREASES, TAX MEASURES AND MONETARY RESTRICTIONS WILL ALL HAVE SOME CONTRACTIONARY RESULT. IN ADDITION, THE PROPOSED MAXIMUM LIMIT ON SALARY INCREASES, IF IT CAN BE BROUGHT INTO EFFECT, WILL REDUCE AN IMPORTANT COST PUSH FACTOR IN SPANISH INFLATION. ALL OF THE MEASURES ARE IN THE RIGHT DIRECTION, BUT WILL PROBABLY NOT BEGIN TO REDUCE SIGNIFICANTLY UNTIL NEXT YEAR EITHER INFLATION OR THE BALANCE OF PAYMENTS DEFICIT. CONTRACTION OF THE MONEY SUPPLY IS LIKELY TO BE GRADUAL, AND THE HOPED FOR TRANSFER OF RESOURCES TO EXPORTS AND TO IMPORT SUBSTITUTION AS A RESULT OF DEVALUATION WILL TAKE TIME. EVERYTHING DEPENDS ON HOW SUCCESSFUL THE GOVERNMENT IS IN IMPLEMENTING THE BASIC ELEMENTS OF ITS PROGRAM AND HOW SOON. THE MOST IMPORTANT QUESTIONS ARE HOW SEVERE THE MONETARY CONTRACTION WILL BE AND HOW SUCCESSFUL THE GOVERNMENT WILL BE IN GAINING LABOR ACQUIESCENCE TO ITS WAGE CONTROL PROPOSALS AND PARLIAMENTARY APPROVAL OF THE TAX REFORMS WITHOUT WHICH WAGE RESTRAINT WILL BE UNACCEPTABLE. EARLY PUBLIC REACTION TO THE POLICY PACKAGE HAS BEEN VAGUE BUT LARGELY NEGATIVE, PARTLY BECAUSE MANY DETAILS ARE NOT YET UNDERSTOOD OR KNOWN, PARTLY BECAUSE THE PROPOSED REFORMS HAVE STRONG

SOCIAL OVERTONES, AND PARTLY BECAUSE EACH ECONOMIC
GROUP IS SUSPICIOUS THAT IT WILL BE REQUIRED TO BEAR
THE LION'S SHARE OF THE BURDEN. SUAREZ WILL HAVE TO
MUSTER ALL THE SKILLS HE HAS DEMONSTRATED IN
ACHIEVING POLITICAL REFORMS TO GAINING ACCEPTANCE OF
ECONOMIC AUSTERITY AND REFORM. STABLER
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